CHADD GARCIA ON PREFERRED SHARES PODCAST
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Lawrence Hamtil: Hello and welcome to episode nineteen of the Preferred Shares podcast. My name is Lawrence Hamtil and as always, I'm joined by Doug Ott and Devin Lasarre. Today we're going to be talking about a very unique entity, the Texas Pacific Land Corporation, which is commonly referred to as TPL, which is also its ticker symbol. TPL traces its roots back to the years just following the Civil War, making it one of the oldest companies that's still in operation in some form or other today. To guide us through this fascinating story is Chadd Garcia, manager of the Ave Maria Focused Fund, which was started in 2020. Chadd has owned TPL in the Focused Fund since 2020, but the Ave Maria family of funds has owned TPL since 2016. Firmwide, it is the largest position for them. So, Chadd, thank you today for joining us and helping us navigate this very interesting story. Why don't you tell us how you got interested in it and where you started your work on it?

Chadd Garcia: Yeah. Well, one of my colleagues went to a conference and ended up sitting next to somebody who works at Horizon Kinetics. And Horizon Kinetics is a long-time shareholder of TPL. I think at the time they owned probably a quarter of the company, 20-25% of it, and at present they own around 16% of it. So long, storied shareholder of TPL, their holding goes back to the 1980s. So that got my colleague interested in it. He did some work on it. And then in my previous life, before coming to the Ave Maria Mutual Funds, I worked with a gentleman who built up a pretty large Marcellus natural gas position, so I had some experience in it. So, I started doing some work on it as well. And a couple of us follow it pretty closely, but I spent a lot of time on it given its importance to our funds overall, and it's one of my holdings as well.

Lawrence Hamtil: Sure, and if I'm not mistaken, the early history dates back to around 1871, and it was a railroad that at some point, I guess, went bankrupt. And so, the trust was formed to sort of deal with the assets and for the beneficiary of the debtors to the railroad. Is that correct?

Chadd Garcia: Yes. It was started in 1871 as the Texas and Pacific Railroad. It never ultimately operated. They were just trying to build the railroad. And then as it worked out, if you were an investor group, and you were building a railroad for every mile that you built, land was granted to you. And so, they built 972 miles of track. They received 4.9 million acres. 3.5 million of those acres were in Texas at one point. It was controlled by Jay Gould, the famous financier. In 1888, it ultimately went bankrupt. And it was because they couldn't lay as many miles as they had as they were obligated to. And so, it went bankrupt. The bankruptcy court put 3.5 million acres, the Texas acres, into the trust for the benefit of the bondholders who financed the building of the railroad. That became the Texas Pacific Land Trust. And at some point, the trust became publicly traded. The official date is 1927. But I heard recently that the New York Stock Exchange did some work on it, and they can find pieces of it trading in various forms back to 1888, which, if that is true, would make it the seventh longest listed company on the New York Stock Exchange.

Lawrence Hamtil: But the real value of the land really had nothing much to do with railroads, right? It was basically when Texas became a big oil player that all the assets that the trust owned really started to rise in value. Is that true?

Chadd Garcia: Well, partially true. That's certainly where the value is today. But so keep in mind that the commission that the courts gave to the trustees when they formed a trust was to sell the assets of the trust which were which was land, and then with those proceeds return the capital to the to the unit holders via dividends or share repurchases. And the trust held true to that mandate throughout the years until recently. And you would imagine that there's got to be some land that they were given that probably had some good use for it, you know, as houses or highways or whatever, because that land was close to metropolitan areas, and so that land having high value for other uses was probably sold off pretty quickly. So, you know, this organization started with 3.5 million acres of land. And when I started looking at it just under a decade ago, it's just under 900,000 acres of land. And so what was left was land that's in the most desolate part of, of our country, which is West Texas, which probably had very limited uses, just scrub land, you know, perhaps you can ranch a couple head of cattle on it and that's about it. But over time it was like 1920s, they discovered some oil in West Texas. And of course, at the time this was all vertical conventional drilling. And so, it produced a little bit of oil. And, and the trust received some oil royalties for its positions in those oils in that land. And then 90 years later in the twenty teens when fracking became prominent, it really became highly valuable and what it is today.

Lawrence Hamtil: And it seems like it's really turbocharged since the advent of fracking and since 2014 or so. Does that seem like that has made what was a good business even better? Is that kind of a fair assessment?

Chadd Garcia: Well, if you look at $600 million in revenue in 2023, with over $500 million in operating profit, if you go back to 2010, it was probably $20 million in revenue and $15 million in operating profit. So, yes, fracking did turbocharge the business. And frankly, they probably had twelve employees back in 2010, and their payroll was $1 million. You know, today their payroll is $50 million, and a majority of the profits are still tied to those oil royalties. And if you still have those ten employees, you probably could get along just fine. But throughout the last decade, one really good decision that the management team made was to get involved in the water business to support the fracking, because fracking is very water intensive. You need brackish water, which is water that comes from an aquifer that you use in the fracking process. And then ocean water was trapped with the organic material that became oil and gas millions of years ago. And so that there's a lot of water

that's mixed with minerals. And when oil and gas come up, water produces it. That's been underground for millions of years. If you look at the Delaware Basin, where TPL is very active, one barrel of oil produces 4 to 5 barrels of water. So really, they say that you have water wells that have a little bit of oil with them.

Lawrence Hamtil: Right.

Chadd Garcia: And so that water is probably 8 to 10 times saltier than the ocean water. Plus, it has oil and gas in it, plus it has some frack chemicals in it. So, you really need to clean that water and then dispose of it. And you dispose of that in what they call saltwater disposal wells. TPL, being the largest landowner in Texas, there's no reason anybody should have a better water resource for them. They have the land in the right place. The land costs them nothing. It was free. And so, they did build out a water business. That's pretty sizable today.

Lawrence Hamtil: Yeah. I was going to say, I think you and I have chatted about this offline and what took them so long to build this out, right? I mean, in retrospect, it seemed like a no brainer, but it was in 2017 that they started to put money into that and build that out.

Chadd Garcia: Yeah. 2016, 2017. And so, I mean, let's unpack it a little bit. I mentioned you have two different types of water businesses. You got brackish water. So that's the water that comes out of aquifers that TPL builds. They built out a very large infrastructure to deliver that water to E&P companies. They probably spent $150 million on that. And you get the land for free. So, if you had to replicate this, it would probably cost multiples more. And then you have the produced water business. So that's the water that flows back from wells. They don't do much handling of the produced water or much cleaning of it, but they do have the disposal wells on their property. Other organizations oversee the handling of it and the cleaning of it and place it in the disposal wells, and TPL gets a royalty on that. I give the management a lot of credit for making the decision to get into that business. You know, in retrospect, is there any criticisms like, yeah, maybe they could have built the produce water business too. And, you know, the returns would be a little bit lower.

Chadd Garcia: But you know, it definitely investing in that business is definitely would have been a good use of capital. But what took them so long? Well, first, fracking wasn't all that prevalent 15 years ago. And so, there wasn't the need as there is now. And then if you look at the history of the company, the commission, you know, the mandate from the judge in the 1880s was to take excess capital and return it to shareholders or unitholders at the time via share repurchases and dividends. It wasn't to put the money back into the business. And so even in 2016, 2017, when the management team deployed capital into this, into this business, I mean, there were a lot of shareholders that were genuinely upset about it. And even recently, there's still talk of some shareholders wanting them to spin that business out and get TPL to be more of the pure play royalty company that always has been. That decision was not without controversy, but it was a good decision.

Lawrence Hamtil: I have another question to which maybe you have some perspective on is why is this unique? I mean, there are so many railroads that went bankrupt in the 19th century. And do you know if there's any other incident of some similar structure? Or is this just sort of like very unique situation that developed the way it did or did maybe other trusts wind down far sooner?

Chadd Garcia: Yeah, I don't know about the history of how other railroads went bankrupt and wound down. But it really was a stroke of luck that the Permian Basin is in the most desolate part of the country, and they were building a railroad through it, and they ended up with a lot of land that they pretty much couldn't sell. And land that 150 years later became some of the most valuable real estate in the country. There's a lot of ways that you can look at how unique the entity is. I mean, if you look at just the financial performance alone in the last year, the company the stock was up 170% in the last five years, is up 400% in the last ten years, is up over 3,000%. In the last 20 years, it was up 16,000%. And then I found stock price information going back to 1980. And I didn't find anything before that. But I didn't dig too hard. But going just going back to 1980, it was up 56,000%. It happens to be, I'm pretty sure, the second company that Warren Buffett ever bought. So, you know, you have a little bit of Warren magic on it.

Lawrence Hamtil: But did he hold on to it?

Chadd Garcia: I Don't think so. He did mention it not at the last meeting but the two previous meetings.

Devin Lasarre: There's also Laurence Goldstein, who I believe purchased it maybe the year after Warren. He was maybe 13 years old or so, and I believe he's still a holder.

Chadd Garcia: He still holds it. And I am pretty sure that he claims that Warren told him that he had he didn't hold it. But, you know, that's all secondhand. So, who knows?

Lawrence Hamtil: Well, I'm just curious, has the thesis changed at all? I mean, certainly the things have developed for the better with fracking and things like that. But I mean, I'm just curious, is it just an incidence of people saying, hey, we can buy prime real estate with good resources underneath the ground? And it's a long-term hold given the insatiable demand for energy. I mean, I'm assuming that's been kind of the core thesis all along.

Chadd Garcia: I don't think even 15 years ago, people thought that the Permian Basin was going to be as big as it was. And so, look how cheap you can buy land in Texas. You know, this company has a million acres of it, and it trades for X price. And you can buy land really cheaply. And there's some oil and gas royalties, not too much, but some. And I think the thesis has certainly changed after the advent of fracking.

Chadd Garcia: Yeah. I think going back to what you touched on, Lawrence early on, early 20th century, part of the thesis most certainly was the rigidity and the long-term duration of the asset, which was perhaps underappreciated. I mean, nobody could have foreseen the advent of fracking, but you did have high margin streams from the activities occurring on this land and, you know, land, they're not making any more of it. You can hold it essentially indefinitely. And there's going to be some residual cash flows, split off for an exceedingly long period of time, with some high degree of visibility for kind of the base rate from back then getting back to the uniqueness we talked about. Warren's Berkshire has a unique shareholder base. I think TPL is probably one of their shareholder base is one of the closest with respect to having a very long-term investor. And if you look at it, you can probably break those out into two categories. First is you have Texas families, retail investors that have owned it for decades, and it worked really well for them. And if it works well, then why would you sell it? You just keep holding it. And then Horizon Kinetics

has had it for a long time. They're very vocal about their position in it. It has worked out very well for them. And you have retail and professional investors who kind of ride Murray's coattails into this trade. And that leaves you with a shareholder base that is very reluctant to sell the stock. It's a very long-term shareholder base. And so, in that respect, it's not unique but it's rare. And then for the longest time there was no good public comps to it. You know there's royalty companies, but royalty companies are different from companies that have the land component too. The only comparison that you have today is, is LandBridge, which has about a quarter of the acreage TPL has on the surface and a little bit less on the on the royalty perspective. And they went public in June 2024. So, you know, we have a recent comp.

Devin Lasarre: Have you done any math to try to estimate all of these long-term holders? How much of the outstanding is essentially held by permanent capital? What is the actual kind of float on this ballpark, or is that just too hard to kind of parse through the numbers?

Chadd Garcia: I mean, you can get back into like the big institutions, but the retail ones are not going to show up. But now you can see with the indexes owned, because it did get inclusion into the S&P 400 in June and then ultimately into the S&P 500 a few short months later in November. So, you can see what percentage the index has. And then Horizon is still around 15-16%. You can see the other large institutional shareholders, but with respect to the retail, no, but if you go to meetings, you often see them.

Devin Lasarre: I did want to go back for a second and talk a little bit more about the water business really quickly, and just their decision to actually get into the sourcing, the water sales and building out that business. And I'm curious on kind of what was the initial rationalization for actually having that managed internally rather than simply outsourcing that? Again, you have less control, but again, ultimately, perhaps higher margin, you're collecting off of the operators.

Chadd Garcia: Well, I think it just I mean, you'd have to ask management that question. And they're not always the most communicative with the shareholders. It probably was viewed as like they have the capital. The water facilitates drilling on TPL land, which facilitates their other surface related activities and will help bring out the oil that they own quicker. And so, it facilitates the royalty business. And then having a team in place. It was

a team. They basically just picked up a team from EOG. And so, you know, having a team kind of already built out in place that they could pick up. So, it's probably a combination of all of those.

Devin Lasarre: That makes sense. And along with that there is some correlation between the amount of water a well kind of produces over its lifetime on a per barrel basis. Is that right?

Chadd Garcia: Well, it depends upon like the basin.

Devin Lasarre: But, um, speaking of the Permian kind of.

Chadd Garcia: Yeah. Well, and it goes up over time. So, the amount of produced water that comes out of a well increases as the as the wall ages. And I've seen that in the Delaware Basin. And then I'm also involved in a company called Secure Waste Infrastructure that manages and cleans and disposes of produced water in Canada. And they're seeing the same thing in Canada.

Lawrence Hamtil: Chadd, I have a question which is, given the uniqueness of the situation there, what do you think is the best way I should ask in terms of figuring out if you're overpaying for this? Because obviously we know the unique advantages and a lot of great tailwinds for it, especially if data centers come to fruition and nearshoring and all these different things. But I'm just sort of curious, what do you think is the best way to think about the valuation here?

Chadd Garcia: Yeah, that's a tough one because, you know, again, there's not too many public comps. You have LandBridge, right? And then it's not covered by Wall Street. It's probably the only company in the S&P 500 that has one analyst that covers it. A smaller kind of regional, less well-known bank, and it often looks expensive, but it often surprises to the upside because there's just so many call options with it. And so, if you go through the business, you can look at the royalty business and the kind of growth rate based both on volumes and the kind of the price that they get paid. TPL had a much larger mineral portfolio in its history, and it was spun out in the 1950s, and TPL was left with a nonparticipating royalty interest in what was spun out. And what was spun out was

ultimately acquired by a couple different entities and ended up with Chevron. And so, what I do when I'm doing the evaluation and looking at what the royalty business could come is as I look over at Chevron, because a lot of their Delaware Basin physician is the stuff that's tied to that was tied to the to TPL. And if you go back and you look at their 2023 Q2 slide deck, they show you the projected growth in the Delaware Basin, going to be like 2040. And it's almost like a linear progression upward in volumes. And so that's their drill plan for the next 15 years. And if you look at how much minerals we can extract, it's probably 5-10% of the minerals that are in the ground we can extract given current fracking technology.

Chadd Garcia: But that that technology gets better over time. And so TPL has an ample amount of minerals that has a royalty claim on Chevron, is one of the bigger producers on their property and is producing and it's forecasting to grow their volumes over the next 15 years. And that's just with current technology not assuming that technology gets better, where if it does, if it goes from 10 to 20%, you basically get a second bite at the apple. And so on. From the valuation perspective, I find it easier just to go through the parts of the business forecast out what you think the royalties are going to be. Look at the other parts of the business, the slim business, which is the surface easement business, you know, see how that's growing and make some assumptions there. And then the same thing with the water business. And then after that you start to get into some of the call options. And so, you mentioned the data centers. You know, one of the theses that has made a lot of news recently is placing data centers in the Permian Basin. I've been investing in data centers for about a decade, and I'm excited about this thesis. But I'm also a little bit more cautious than a lot of the TPL bulls are, you know, there are a lot of use cases for data centers that make absolutely zero sense for them to be in the Permian Basin. And so, if an application requires low latency or a lot of speed, it's not going to be run on a data center in the Permian Basin.

Chadd Garcia: So, for example, you know, if you're in Kansas City, there's probably an Equinix or a Coresight data center near you. And if you want to watch Netflix or if your kids want to watch Disney Plus, there's going to be a data center near you where all of Netflix's content is going to be within it, and your cable provider is going to be plugged into their servers in that data center. And if you're going to watch Netflix, your cable internet provider is going to get it to you via that data center, stuff like that. It's not going

to be in the Permian Basin. But you know what could be, you know, what doesn't have the latency requirements like that? Large language learning models. Large language learning models, you know, aren't at this point, aren't latency or time sensitive. And they require a lot of energy. Data centers that house those can be put in the Permian Basin and take advantage of the trapped natural gas that's there and have a cheap energy source to power them. That makes a lot of sense. Now, I don't know how long large learning models will be important or if we go to inference, but to the extent that they're around for a long time, I can see that. I can see them even being placed there to take advantage of, first natural gas, and then second, all the space where you can co-locate solar or wind or other energy resources.

Lawrence Hamtil: To that extent. And this is just me and my ignorance. But on the data center question, what about the operating temperatures? I mean, they require a lot of cooling. The Permian Basin, I'm guessing, is pretty dry, pretty hot. Do you think that is any sort of constraint on that, or is it just easily done with cooling technology now?

Chadd Garcia: I think it's easily done with cooling technology. You need the power to power the data centers, and you need the water for the cooling. And they have water there. They have brackish water. And to some extent, you know, they have the produced water that comes back that we discussed. But then you start to look at the cost to clean it. You can take produce water and get it to medical grade, but you know, it comes at a high cost. My suspicion is that if the data center thesis plays out, most of the water will probably be from brackish water sources, and you might probably will blend in a little bit of produced water that has been cleaned for various ESG and environmental goals.

Lawrence Hamtil: Right.

Devin Lasarre: I have a follow up. I share your skepticism towards the data center call option, just in terms of use cases and not making that into a base case necessarily. And I haven't been studying data centers, not as knowledgeable as you, but I do understand, you know, on a comp basis we now have LandBridge. And if I understand correctly, there is some advantage in that data centers potentially need much larger land footprint. LandBridge has larger contiguous pieces of land relative to TPL. A lot of what they have is

more like a checkerboard system throughout Permian. Is that right? So, are they a little bit more limited even if that part of the thesis plays out?

Chadd Garcia: Well, TPL has like 600-acre checkerboard pieces and for a data center complex. It's not just one data center. If you're going to put something there and co-locate Paragon, you're going to want to produce a data center campus. And so, you know, say you need like a couple of thousand acres as opposed to six hundred acres per site. But, you know, TPL can go out and put that together and acquire it and get it going. But I would say that if I'm a LandBridge shareholder as well, actually in the Focused Fund, LandBridge is a bigger position for me than TPL is. But I think that if this data center thesis plays out, you'll probably see it at LandBridge first, just because they have a person on staff that has already worked at a hyperscaler developing data center. You know, this person speaks the language of the hyperscalers, has relationships with them, knows how to get things permitted. And, you know, they have been a little bit more proactive than TPL thus far. It seems to be a little bit more reactive and kind of waiting for the phone calls to come in, as opposed to LandBridge who's out there and trying to make this happen. But TPL is a massive company with a lot of resources. We'll see what they say on the call that they have coming up in the coming weeks. You know, maybe they made a new hire. Who knows?

Devin Lasarre: Right. LandBridge seems to be, I mean, they have a much lower royalty business, you know, in terms of percentage of total sales compared to TPL. And they seem much more focused, at least on what I've heard them articulate on the surface side of things.

Chadd Garcia: Well, if you look at the royalty companies and the multiples that the royalty companies trade for versus TPL, the market's telling you that the value that there's immense value in the land and the water business. And I think what LandBridge's management would say was that the land was the choke point in getting the oil and gas properties developed quickly. And so, if you could put together a large land portfolio, you can facilitate the MPs developing the oil that they own. And so, you know, there was immense value in that. And the multiples show that. You just look at it like a prairie sky in Canada, which probably has one of the best royalty positions of any company. And it's got 70% of the Western Canadian royalties that came from the Crown. So, it's very pure. Plus,

royalties are very pure too because they came from the state. So, oil and gas royalties may have passed through generations of several generations of families being passed on and passed on. There may have been divorces. And so, the title to it is less clean and you have to have landmen to go and prove title, whereas TP's royalty came directly from the state and there's no debate in it, but there's a lot of value in the land. And so, the LandBridge guys recognized that. And so hence they put together the LandBridge business. And in doing so, they acquired land that had some royalties attached to that. And they were fine doing that. But they're not out there trying to buy royalties and build up that side of the business. They're going to buy land, and if the land doesn't have royalties, that's fine. And if it has royalties that are attached to it, that's fine too. But they're not going to specifically look to buy royalties.

Devin Lasarre: Can you walk us through some of the use cases for surface and what easements might constitute, you know, for maybe listeners that aren't as familiar?

Chadd Garcia: Well, if you own some oil and you want to get it, you have to drill a well. And so, you have to make it make a deal with the landowner that owns the surface land above your oil. So, you have to get an easement on the land. You got to build a road to get there. You got to build a drill pad that requires a lot of gravel, which TPL or LandBridge would sell to them. Once you start fracking, you need water to frack. So, you're going to have to source water and put water lines on there when you frack. Often you mix some sand in with the water, so you need some frac sand, which TPL and LandBridge will sell to an EMP company produced water is going to come up, so you're going to need to get the produced water off your property somehow and dispose of it. Oil is going to come up, so you're going to have to put an oil gathering station on or a pipeline. Electricity is going to be required. You're going to have to run power lines. So, all these all these various activities are needed to drill and frack. And every time something crosses a new piece of property; there's an easement that needs to be put in place.

Lawrence Hamtil: Chadd, I have a question. As it relates to capital allocation. I think you've been pretty vocal when I've heard you discussing this, that you think management would be better off just allocating a lot of the capital to repurchases. Is that still your view on that?

Chadd Garcia: There were some big various shareholder fights throughout the last few years. And, you know, and a couple of lawsuits that have occurred between various shareholder parties and the trust or later the corporation during one of them, in 2019, the trust stopped repurchasing shares and then they restarted in 2021, but nowhere to the same extent that they had been prior, and my feeling that if they would have redeployed an ample amount of their excess capital into share repurchases throughout that time the shareholders would be several billion dollars better off. But, you know, look what they have done with the capital. You know, subsequently, they are they built the water business. So good for them. And I support that. They've paid some very large special dividends, which the company has always paid large special dividends. But they got it a little egregiously large in lieu of share repurchases, which has been a bit upsetting for some shareholders. And then they're looking to deploy capital in M&A, and they have done some land purchases. And I support that because again, just look at the valuation differences between pure royalty companies and companies that have the land. And the land company is trading at a premium. And so, I support that use of capital. But they have also been keen on buying large royalty interests. There was a couple that came out in the last lawsuit that the company was looking at buying some royalty interests and there were several billion-dollar transactions, and they would have been required, you know, to issue new shares.

Chadd Garcia: Those deals were ultimately thwarted. And then in the last year, they spent several hundred million dollars buying royalty interests. And my thoughts on them buying a royalty interest is that they have no edge in that game. What are the inputs and outputs of buying a royalty? The input is like the price you pay, how much oil is extracted that you get a royalty on the price of the oil at the time the oil is extracted, and the time that it takes between when you buy the interest and the time of extraction. Well, they don't they're not an EMP company. They don't control the drill bit. They may have some E&P customers of theirs that may kind of give them their drill plans, and maybe they can go pick up a small royalty interest from some family. That would be fine. Go ahead and do that because you have some good, useful information that maybe the maybe the royalty owner doesn't have, but for large 100 million plus billion-dollar purchases, they don't have any informational edge. And if you look at some of the competitors, like Venom, which is a royalty business, that business is affiliated with Diamondback. Diamondback is an EMP company. Venom knows where the drill bit is going to be. They can make sure that if

they're deploying capital, they're going to get that capital back because they know the drill plan of the partner.

Doug Ott: On that issue. It sounds like because TPL has no tight formal relationship with a drilling partner like you were describing that venom has with Diamondback, that there could be some adverse selection going on. Is that right?

Chadd Garcia: Yeah, there could be. And like, what's the biggest risk to this company? We're going to need oil and gas for a long time. The Permian Basin has cheap oil and gas. It's going to get developed. You know you have a water business that's doing really well. You have a royalty business that's going to be kicking you cash for a long time. You have a surface easement business that's going to do well for a long time. It's like, what's the biggest risk of the business? Bad capital allocation. You know, where's the place that they can do that pretty easily in the royalty space. So, I would just prefer that they give up on that. They have no edge. Stick to buying land that facilitates more drilling on your acreage.

Lawrence Hamtil: I have a kind of a follow up question, Chadd, on capital allocation, which is if you've got a and I'm sure management is aware that they've got a pretty sticky shareholder base and so on the margin, you wonder who's going to be the holders who would sell into a buyback? Does that play any part in their thinking as far as maybe going for a special dividend versus a large repurchase program, or do you think that's just overthinking it?

Chadd Garcia: I think it's maybe overthinking it a bit. I mean, if your management should do everything in their power to support what's special about their shareholder base, which they have an exceptionally long shareholder base that doesn't sell. And let's look at that. How that benefited them in the last year. I mean the stock was up three x in 2024. And the stock price really didn't get moving up until June when they were included in the mid-cap 400 index when they were included in that index. They were the second largest component of the index. Ultimately, they became the largest right before they were moved up to the S&P 500. And so, when they were the second largest component of the index, and funds flowed into that index, that created an inelastic demand for the stock. These index companies had to buy it, and they had to buy a lot of it because it was the second largest component. And you combine that with the shareholder base that doesn't

sell. You know, you get an upward movement in the price very quickly. I mean, it went from $500 to $600 plus in a matter of a few short months.

Lawrence Hamtil: That's a powerful combination when you've got people who have to buy and people who won't sell.

Chadd Garcia: It's interesting to get back to the unique nature of it. One of my favorite books and most one value investors favorite books is The Outsiders. And, you know, you get the Henry Singleton chapter, and he talks about buying the stock when it's dirt cheap. But TPLs management really wanted to play this hard. They should just put every access dollar they have back into share repurchase regardless of the price. Because if they maintain that long term nature of their shareholder base and they squeeze out the kind of fickle shareholders, what happens when they're in an index? I mean, it just puts more fuel into that, to that inelastic demand and, and very few sellers' kind of dynamic.

Doug Ott: I have some history to share with you talking about inelastic demand. I found some old articles in the New York Times about TPL, and how it doubled in price in just six weeks in late 1926. It went from $830 per share to $1,670 per share. And there is probably some oil and minerals speculation going on during that time. But to put that in today's dollars $1,670 in late 1926 is worth about $30,000 per share in today's dollars. And so this is exactly why, just a few months after that happened, the company issued sub shares in the business to its shareholders, and these were shares that gave them the right to convert their original shares into 100 smaller denomination shares, a somewhat similar reason as to why Berkshire Hathaway eventually issued a new share class that had a much smaller share price.

Chadd Garcia: Yeah, there's some articles if you search you can find where there's like one bondholder didn't convert and then somebody found the bond and did the research, and it ended up being like 3 or $4 million worth of TPL stock.

Devin Lasarre: I want to revisit the idea of the passive flows post kind of index inclusion. You have this kind of shifting demand profile for the stock, where you have a lot of forced buyers, and you touched on the idea that if management wanted to really lay into it, they would divert every dollar they could into buybacks to amplify the effect of that. But at the

same time, you look at somebody like Singleton, you know, if you think that something is being pushed up exorbitantly high because of passive flows, there's maybe a completely alternative argument, which is maybe the companies should issue a bunch of shares instead, due to the passive flows kind of pushing up beyond the bounds of their ballpark, of their perceived intrinsic value of the assets that they understand.

Chadd Garcia: Yeah.

Devin Lasarre: Well, what do they think it might be worth?

Chadd Garcia: Yeah. The CEO tried to make that case in February of last year when the stock was a third of what it's trading at now.

Devin Lasarre: Right, but I mean perhaps that gives a very contrasting view on what the public perceives it to be worth versus what management, who should have intimate understanding of the assets value, what they're calculating it to be worth, maybe, you know, does that give you any pause?

Chadd Garcia: I think the difference should be given to the shareholders who have been in this long, long before management came around.

Lawrence Hamtil: But I mean, in the final analysis, right? I mean, and maybe I'm wrong, but they have very little in the way of capital needs, right? I mean, there's very limited opportunities, I think, for them to grow, so to speak, so they'd be better off, just like you said, returning the capital to shareholders and rewarding their shareholder base.

Chadd Garcia: I mean, I think there's a place for them to be acquiring more land, which is what really separates the company's value out from that of its peers and goes to if there's going to be a limiting factor in the Delaware Basin on the on the growth of oil and gas, it's going to be on the water side of it. And so, anything you can do to alleviate that and TPL should be in the best position because of their strength. But anything they can do to support that business is going to be good. Yeah. They don’t, I don't think they need to be out there buying royalties. I think they put it back into the share repurchases or maybe pay some dividends now that it's trading at 42 times EBITDA. Go back to the past, go back

to 2019. You know, it hadn't always been trading at 42 times and very frequently management always said that the stock was expensive but proved out to not be the case. And had they been deploying capital into share repurchases, I think the shareholders would have been much better off.

Doug Ott: So, Chadd, anything else to add about capital allocation when it comes to TPL?

Chadd Garcia: Yeah, one thing, Doug, I'm generally not a fan of them spending large amounts of capital on acquiring royalties, but there would be one situation which plays to their strengths that I would be supportive of. So, what is our strength? This business requires very little capital, and it spits out an immense amount of free cash flow. And it has no debt. In periods when you're in a bear market in the oil industry, the prices of publicly traded royalty companies can become wildly dislocated from private values in that scenario. They should use their fortress balance sheet and buy common stock of royalty companies. If not, buy out entire royalty companies. That would be one situation that would play to the company's strength that they could do that I would support.

Doug Ott: Given that preference. Do you know how many total royalty companies are out there, whether they're public or private?

Chadd Garcia: I mean, off the top of my head, no, but I can think of at least five pretty quickly that play in their area.

Doug Ott: And do you think management has that expertise or even willingness to buy interests, whole or in part in other royalty companies?

Chadd Garcia: Well, the CFO is a is a former investment banker. I mean, if you're if you're going to be valuing private transactions, you can do it in a public sense just as easily.

Doug Ott: So yeah. Well, I think there’s one thing about former investment bankers is that they like to do deals. So that could be a good, good, or bad thing.

Chadd Garcia: Well, I think right. I think presently we might be seeing a little bit of the bad thing about it. Yeah. But if but if they're patient, you know, they may get a chance to, to do it the right way.

Doug Ott: Yeah, I like that idea a lot. And it's an infrequent thing where you see a public company outside of Berkshire Hathaway is probably the only example of taking stakes in other publicly traded companies.

Chadd Garcia: Well, you know, I made the comparison with the shareholder base earlier. You know, hopefully we can start making the comparison with capital allocation as well.

Lawrence Hamtil: Do you see any risk as far as like maybe another precipitous drop in the price of oil as we saw from 2014, which bottomed out, I guess you could say in that cycle in 2020. I mean, is there any real risk there, or is that just part of the game? And energy is the cyclical nature of oil prices and boom and bust and so on?

Chadd Garcia: Yeah, I mean, you're definitely exposed to it here because you have the royalty position, right? So, if the price goes down, like the amount of royalties you get paid are going to go down kind of rapidly, but then you also have the other components that are like as long as you're producing, you're still going to need the water. You know, Delaware Basin is pretty cheap. And so, where you would get hurt is like another 2020 style situation is where oil volumes get smoked because there's no demand. And oil prices may go up and down, but something where the volume demand dropped materially is what I've seen one time, you know, not many times.

Lawrence Hamtil: Sure. Yeah. No, that makes sense.

Devin Lasarre: Going back to thinking about forecasting into the future for all these different segments, you have the two big inputs for the royalties, which is kind of the volumes and price, but volumes are somewhat sensitive to price to a degree. Do you think water is more easily forecastable or not so much, because the amount of demand for water and the amount produced is inextricably linked to the volumes produced by the wells?

Chadd Garcia: The volumes in the Permian are going to be a little bit more stable than they would be globally, just because it's a low-cost source of oil.

Doug Ott: Well, let me just ask one more thing. So TPL was a trust that's been around since the late 19th century, and there were at least two earlier shareholder efforts to convert the trust into a corporation. The first was in the 1920s and another time was in the 1950s. Can you speak to why TPL decided just recently to become a corporation after roughly 130 years plus as a trust?

Chadd Garcia: Yeah, I can't speak to the earlier time because I haven't studied up on that. But I lived through the recent conversion and, you know, and to some extent it was almost unfortunate that it became a C Corp because now it's a taxpayer. Whereas when it was a trust, it wasn't. So, it was much more tax efficient to not be a C corp. It's just I don't think the governance was if they could have had the government fixed where the unit holders were happy, then it probably would have been better off for everybody. But you know, that just wasn't the case. And so, if you go back to 2017, when one of the trustees left the board, a new trustee came on; he was a lawyer. A lot of controversies surrounded him, both at the time of his election and then subsequently. So, at the time of his election, it was found out he was elected via broker non-votes and not a true majority. And so, there were some people who questioned the validity of his election, but the chairman of the trustees was a longtime shareholder, or a long-time trustee and longtime unit holder. He became a trustee because it was passed down to him by his father, who was a trustee.

Chadd Garcia: This person's family had an immense amount of their personal wealth invested in TPL. He basically made all the capital allocation decisions with respect to repurchasing shares and paying dividends. I think the unit holders for a long time felt aligned with this trustee. And then in 2019, he, you know, was older, he became fairly ill. He resigned from the board and then shortly after that passed away. But if you go on to be a trustee, you were a trustee until you resigned or until death. And it was you couldn't remove the trustees when this person resigned. That left two lawyers as trustees. They first moved to a point. A real estate executive who had some ties to some clients of one of the lawyer’s law firms, the shareholders or unit holders at the time, you know, didn't like that. And the unit holders proposed their own candidate for a trustee. That set off a very acrimonious battle between the shareholders who were running their own candidate.

And the trust culminated at a shareholder meeting. And I went to it. Several shareholders who went to it seemed like the trustees knew that they were going to lose. And so, they canceled the meeting.

Chadd Garcia: The day of the meeting, the shareholders all gathered at the at the meeting place. Anyway, we held the meeting, and we elected the candidate who came up from the shareholders, the trust, you know, deemed the meeting invalid. That set off lawsuits between them and in the end, because of more controls that the shareholders would have over governance, it was decided to convert to a C Corp had had the governance been able to be fixed as a trust and the shareholders have recourse, it probably would have been much more tax efficient and better for everybody if it remained in trust. But that wasn't the case. And so, it became a C Corp. There were a lot of anti-shareholder provisions set up in the original articles of incorporation and bylaws. It's been a grind since then to change the bylaws and implement more shareholder friendly policies. There's been two wins on behalf of the shareholders. The first win was to stagger the board. The second one which we got recently was the ability to call a special meeting. And so, as time passes, the shareholders are starting to regain a little bit more power and checks and balances over the company.

Doug Ott: Yeah, it's amazing the good or the bad that can come from shareholder alignment versus lack of alignment. It sounds like the longtime trustee that passed away that you mentioned, he had significant ownership. Do you know about the other trustees? Did they have significant ownership in TPL?

Chadd Garcia: It was small. And then if you go fast forward to today, I mean, the stock that management has is stock that's been given to them. Like you don't see them write in checks, which is unfortunate. And it's been unfortunate for them too because they hadn't been doing that since their tenure. They would have been much richer.

Doug Ott: And can you talk to us about the current compensation structure for the directors now?

Chadd Garcia: Yeah, I mean, less so on the directors. I mean, they're I mean, the trustees were paid $2,000 if memory serves per year and that was set by the trust documents. And

the chair was paid $4,000. There was a controversy, you know, once the old trustee resigned that the remaining two up their comp to a little over $100,000, which is reasonable, but they did it unilaterally and it went against the trust document. So that's like another that was another kind of contention between the unit holders and the trustees. Now the board is paid reasonably good for the size of the business. So, I don't have any complaints there with respect to management. I do have some complaints about management's comp because it seems to me that the compensation structure of management provides incentives for them to do the types of deals that we don't want them to do, which is buy royalties. I mean, they have a free cash flow per share metric, which sounds like a really good metric for most businesses. I mean, I would like that in a lot of my businesses, but if you have that in this business, if you look at the decline rate for a royalty, if an oil well is fracked, you get a lot of amount of oil up front and then it declines fairly rapidly. And so, if you have a free cash flow per share metric where you're paying a bonus on a manager can go out there and acquire royalties. And the first few years after acquisitions, it's going to juice the free cash flow per share. But that may decline fairly rapidly. And in the end, it could be a value destructive acquisition. And so, there's little stuff like that that annoys me a bit.

Doug Ott: So, for a royalty company, what would be the most appropriate incentive scheme if it were not free cash flow per share?

Chadd Garcia: Yeah, I think that it's tough. It's tough because it doesn't. The uniqueness of this company doesn't lend itself to traditional compensation metrics. Well. But I think if you look to Canada and look at Prairie Sky, like they do a really good job with this. If there's going to be any risk to the company, it's inappropriate capital allocation. And so how do you align management with the shareholders for the long term? And if memory serves correct, half of the stock grants at Prairie Sky vest within three years. But management doesn't have access to that capital until they leave the company. And so, they're going to be stuck with the bad decisions or good decisions like, you know, for half of the shares that they're granted. And so, I think that that kind of long-term tying the stock to management is probably appropriate where capital allocation is the key metric or the key risk for the company. I did bring this up to the chairman of the compensation committee, and they said, you get into a position where they're just overly concentrated in our stock. And I'm like, well, you know, like.

Doug Ott: That's a good thing.

Chadd Garcia: That's a good thing. I mean, maybe I'm a little less sensitive to it because I run a focused fund with fifteen positions and my largest company is 20%. But if the management doesn't want to be highly concentrated on their own stock, you know, maybe, maybe we don't want them there.

Doug Ott: Yeah, maybe they need to find something else to do.

Chadd Garcia: Yeah. Yeah.

Lawrence Hamtil: Well, Chadd, it's been a wonderful discussion. We really appreciate you joining us and discussing TPL and kind of enlightening our listeners as well as us on this very unique company. And where can listeners contact you if they want to, or find your writings or follow you? Do you have any platforms that you'd like to promote or put out there?

Chadd Garcia: They can find us on our website at www.avemariafunds.com. We have quarterly commentaries, and I'll write a lot about what's going on in the Focused Fund posted.

Lawrence Hamtil: All right. Well thank you so much. We appreciate it.

Devin Lasarre: Thank you, Chadd.

Doug Ott: Thanks, Chadd.

Chadd Garcia: Yep. My pleasure. Have a good day.

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